Supreme Court, U.S.
FILED
JAN 2 1992
OFFICE OF THE CLERK

(6)

No. 90-1918

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),

Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Respondent.

On Petition for a Writ of Certiorari To the Supreme Court of Iowa

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SUPPLEMENTAL BRIEF OF PETITIONER

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Uncharacteristically, the Brief for the United States is in part misleading and in part inaccurate. It also relies upon a curious and unsupported constitutional theory. Its recommendation should therefore be ignored.

The United States makes two main points. First, it suggests that the issue here presented was disregarded by both this Court and counsel in *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980), because of a presumed lack of merit. Second, under the novel theory it advances, the United States contends that there is insufficient evidence in the record

to determine whether the Iowa taxing scheme impermissibly discriminates against foreign commerce. The United States is wrong on both counts.

I. The Relevance of *Mobil*

A careful reading of *Mobil* reveals that the discrimination issue here presented was *intentionally* not raised there as part of counsel's complex "litigation strategy." See 445 U.S. at 434. The reason is clear. Mobil's "foreign source" dividends came from *two* sources—certain foreign subsidiaries and Arabian American Oil Company (Aramco), a Delaware corporation doing business overseas in which Mobil owned a 10 percent interest. *Id.* at 435, 430 n.5. (Approximately 66 percent of Mobil's dividends in at least one of the years involved came from Aramco. *Id.* at 457 n.10.)[1]

The discrimination argument petitioner raises here would not apply to the taxable portion of dividends received from a *domestic* corporation such as Aramco engaged in business in a foreign country. For that reason, it is understandable why Mobil's counsel did not raise the point here at issue, but chose instead to challenge the Vermont tax on four other constitutional grounds, all of which applied to its Aramco dividends. To suggest, as the United States now does, that the discrimination claim raised here "was not sufficiently apparent to provoke consideration by Court or counsel in the *Mobil* case" (Br. U.S. 7) is not only gratuitous, but totally misleading.

[1] With only a 10 percent interest in Aramco, Mobil enjoyed only an 85 percent deduction for the Aramco dividends it received. See 445 U.S. at 435 n.12.

II. The Novel Theory Advanced by the United States

The United States argues that in order to decide whether there is "discrimination" under the Iowa taxing scheme, this Court must determine not merely how foreign and domestic subsidiary dividends are taxed by Iowa, but how "total income streams" are taxed. (Br. U.S. 9) (A "total income stream" presumably includes both the earnings from which dividends are paid and the dividends themselves.) Iowa's tax treatment of dividends is said to amount merely to facial "differentiation," not facial "discrimination." Such differentiation, the argument goes, "does not necessarily imply that the total income stream of a foreign subsidiary is subjected by Iowa to a greater or lesser total tax burden than that of a domestic subsidiary of the same unitary enterprise." (*Id.*)

The United States bolsters its argument by noting that the earnings of a domestic subsidiary that may be taxed "by Iowa and other States on an apportioned basis" may bear an overall tax burden that exceeds that borne by "foreign source income" under the Iowa scheme. (Br. U.S. 9 n. 9) Finally, the United States asserts that there is "no evidence in this case" of the tax treatment afforded similar items of income by foreign governments. As a result, it argues (quoting the trial court completely out of context) that petitioner's claim of facial discrimination against foreign commerce is "entirely 'speculative'." (*Id.*)

The theory advanced by the United States is surely novel. Petitioner is aware of no case decided by this court that has evaluated a claim of discrimination under one State's taxing scheme (i.e., Iowa's income tax on dividends received by parent companies doing business there) by taking into account not only (1)

the taxing schemes of other jurisdictions (i.e., other States and foreign governments), but also (2) the application of those taxing schemes to income earned by other entities (i.e., the income earned by the dividend-paying subsidiaries).[2]

In fact, this Court's decisions in *Armco Inc.* v. *Hardesty,* 467 U.S. 638 at 644-645 (1984) and *Tyler Pipe Indus. Inc.* v. *Washington Dept. of Revenue,* 483 U.S. 232 at 247 (1987), clearly establish the inappropriateness of any reliance on taxes imposed by other jurisdictions in determing whether a particular tax is facially discriminatory. The theory advanced by the United States is in direct contradiction to the holding of those cases. While both cases involved discrimination against interstate commerce, no decision of this Court indicates that the rule is otherwise when the claim involves discrimination against foreign commerce. If foreign commerce is to receive different treatment, as the United States seems to claim, surely a rule of such magnitude should be declared by this Court.

Even if the tax schemes of other jurisdictions are to be considered, how they apply to *other entities* cannot be relevant. In *Mobil, supra* at 440-441, this

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[2] The United States claims to find some support for its novel theory in the examples provided by respondent in its Brief in Opposition (pp. 8-10). The examples seek to support respondent's position that a claim of discrimination against foreign commerce must be tested by determining whether a benefit or advantage is afforded to local (in-state) commerce (not domestic commerce generally). None of the examples addresses the comparative tax treatment of foreign and domestic "total income streams." Interestingly, the United States clearly disagrees with respondent on the local v. domestic commerce issue. (Br. U.S. 9-10)

Court made it clear that, as a matter of Due Process in the context of a unitary business, a state that could tax the underlying earnings of an unincorporated foreign division could instead tax the dividends paid by that division if it operated as an incorporated foreign subsidiary. But that is a far cry from contending, as the United States does here, that in determining whether Iowa's tax *on such dividends* is discriminatory, it is necessary to take into account how the underlying earnings of the dividend-paying subsidiaries are also taxed. Such a theory completely disregards the separateness of the taxes imposed on the different entities involved. Cf. *Container Corp.* v. *Franchise Tax Board,* 463 U.S. 151, 191 n.30 (1983).

As for the alleged deficiency in the record below, the trial court specifically found as follows:

> In 1981, Kraft's foreign subsidiaries declared and paid dividends to Kraft. The foreign countries in which these foreign subsidiaries were located required the subsidiaries to withhold income taxes imposed by the countries upon the declared dividends of Kraft and to remit such taxes. In addition, the foreign subsidiaries were taxed directly by the foreign countries upon their earnings, from which the dividends to Kraft were declared. Thus, the foreign countries, utilizing the "arms-length" approach to income taxation, taxed the earnings represented by the foreign dividends twice, once to the foreign subsidiaries and second to Kraft.

(Pet. 12a. See also Pet. 2a; Pet. 29a-30a, Stip. 7-8; and Pet. 52a-53a.) The record thus clearly shows that five different countries taxed both the underlying earnings of petitioner's foreign subsidiaries and the dividends remitted by those subsidiaries.

Thus, even if it were somehow appropriate to consider the taxes imposed by other jurisdictions on other entities, the record below fully supports petitioner's claim of impermissible discrimination by Iowa. Three separate layers of tax have been imposed on the total income stream of petitioner's foreign subsidiaries—a foreign income tax on underlying earnings, a foreign withholding tax on dividends when paid, and an Iowa tax on those dividends when received. (Pet. 12a, 14a)[3]

The income stream of a domestic subsidiary carrying on business in the U.S. cannot be subjected to a similar tax burden. The only comparable taxes that could be imposed on a domestic subsidiary's underlying earnings would be the income tax imposed at the federal level, and whatever income tax may be imposed at the state level. Iowa does not, of course, tax domestic subsidiary dividends when received.

A maximum of two layers of tax on the income stream of a domestic subsidiary, compared with three layers of tax on the income stream of petitioner's foreign subsidiaries, undeniably establishes the existence of an impermissible burden on foreign commerce and resulting preference to domestic commerce under the Iowa taxing scheme.

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[3] A potential fourth layer of tax, the federal income tax also imposed on foreign subsidiary dividends, was offset by allowable foreign tax credits. (Pet. 32a, Stip. 16)

The facially discriminatory nature of the Iowa tax statute makes a determination of the degree of such burden and preference irrelevant. In *Bacchus Imports, Ltd.* v. *Dias*, 468 U.S. 263 (1984), a case involving facial discrimination, this Court expressly reaffirmed the well-settled proposition that it "need not know how unequal the Tax is before concluding that it unconstitutionally discriminates" (quoting from *Maryland* v. *Louisiana*, 451 U.S. 725, 760 (1981)). 468 U.S. at 269. See also *Armco Inc., supra.*

Significantly, the analogy between *Armco* and the instant case is virtually perfect. Under the West Virginia taxing scheme there involved, if an item was manufactured in West Virginia a tax *was not* imposed on an in-state sale of the item at wholesale. Instead, a tax was imposed on the manufacturing activity in the state. By contrast, if the item was manufactured out-of-state, a tax *was* imposed on its in-state sale, whether or not there was also a manufacturing tax imposed in the seller's home state. This Court held that the West Virginia tax scheme facially discriminated against interstate commerce.

Here, if the income is earned by a domestic subsidiary, Iowa *does not* impose a tax on the dividends paid from those earnings, whether or not the subsidiary's income is taxed by Iowa or any other state. By contrast, if the income is earned by a foreign subsidiary, Iowa *does* impose a tax on the dividends paid from those earnings, whether or not there has also been a foreign income tax imposed on the same earnings and/or a foreign withholding tax imposed on the dividends themselves. Since the facial differentiation in the West Virginia taxing scheme constituted impermissible "discrimination," the facial differentia-

tion in the Iowa taxing scheme must also constitute impermissible "discrimination."

* * *

The instant case raises for the first time one of the most fundamental constitutional questions presented under the Foreign Commerce Clause—the scope of the third prong "discrimination" test of *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977), as extended to foreign commerce by *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979). In its decision below, the Iowa Supreme Court made known its doubts about how that test is to be applied. ("...Supreme Court decisions are unclear whether such a local bias must be found when discrimination against foreign commerce is alleged. . . .") (Pet. 7a.) The Rhode Island District Court, Sixth Division, in a decision involving the identical issue here presented but rendered after the petition was filed in the instant case, expressed similar uncertainty. ("The Supreme Court seems to be adopting a laissez-faire attitude in these cases (except for *Japan Line*).") (*Dart Indus.* v. *Clark*, June 19, 1991, Slip Op. 5, lodged with the Clerk of this Court.)

Iowa, along with Rhode Island and eight other states (Pet. 6-7), disadvantages companies that rely for capital on dividends from foreign subsidiaries and benefits companies that rely for capital on dividends from domestic subsidiaries. It does so by exposing capital generated in foreign commerce to an additional layer of tax to which capital generated in domestic commerce is not exposed. Individual states are not free to burden foreign commerce and benefit domestic commerce in such a manner.

State courts are groping to determine how properly to resolve the important question presented by the instant case. The arguments offered by the United States as to why the petition should be denied are based on an inaccurate reading of the record and a novel and unsupported theory of constitutional law. The views of the United States thus should be accorded no weight in this Court's deliberative process.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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